Our View

October 2019

Preface

Third quarter returns for equities and bonds were mostly positive (Table 1) and mark a continuation of the narrative that low and declining interest rates are good for both equity and bond markets. The past is not necessarily prologue, but year to date there has been a bull market in optimism. For example, the S&P 500 has appreciated over 20%, while S&P 500 earnings have grown only 1.5%[1], the difference, of course, is an expansion in valuation multiples. Earnings will need to accelerate, or investors may grow concerned that stock prices are ahead of fundamentals, and this may be a tall order with global growth slowing and wage pressure rising.

Table 1: 2019 Performance YTD[2]

Index	Q3	YTD
S&P 500	1.7%	20.6%
MSCI All Country World Index ex -U.S.	-1.7%	12.1%
Barclay's Aggregate Index	2.3%	8.5%
Barclay's Global Aggregate Index	0.7%	6.3%

A common question we hear is "where do we go from here?" Our focus is on investing, and it requires a timeframe that exceeds both the average news clip lifecycle and a few calendar quarters, or even a short number of years. Probabilities are rarely empirically certain. "How will Brexit turn out?" "Will the President be impeached or convicted?" are very hard questions to assign probabilities to. However, analysis of the relative level of valuation for asset classes, determining if underlying growth rates are above or below historical averages, and what could impact growth rates going forward is possible. At the moment, this analysis leads us to a cautious conclusion and, of course, the issue of impeachment will be disruptive.

Current Positioning

Our positioning in portfolios has not materially changed. We remain cautiously positioned, with the ability to redeploy assets when we see better fundamentals. To illustrate our thinking let's review three specific factors: growth, valuation and policy:

- **Growth:** Most global economies are growing (real GDP), but recently the rate of change has been negative, meaning that global growth rates have been decelerating. We are watching this carefully for signs of reacceleration, or further deterioration.

- **Valuation:** Equity valuations range from average to expensive depending on the geography and metric. However, equities are attractive when considered relative to extremely low bond yields. Today, the yield on over **$16 trillion** of global sovereign debt is negative. In that regard we think that negative yields are disruptive to banking systems, a negative for savers, pension funds, and ultimately the pricing of risk.

- **Policy:** Policy can be divided across several variables: trade, monetary, and fiscal:
    - U.S. trade policy is causing uncertainty, intentionally for China, and unintentionally for U.S. business and much of the rest of the world. A normal reaction to uncertainty is to pause, which means less hiring and less capital expenditure. While the U.S. jobs market remains strong, capex spending has been weak, and business confidence surveys are declining.
    - Monetary policy in the U.S., and generally around the world, is easing which is supportive for risk assets. If inflation were to increase (wage growth has accelerated the last two years in the U.S.) the Fed may find itself in a quandary regarding further rate moves. A rate increase would be negative for equities.
    - Outside of the U.S., fiscal policy remains an underutilized lever. In Europe there has been significant resistance to increasing fiscal spending to avoid incurring larger deficits. However, with interest rates so low, intelligent fiscal spending on high return projects would be beneficial to economic growth.

We are increasing our research time and focus toward Asia with an eye toward capturing the meaningful long-term tailwinds that we see. However, we would be remiss not to acknowledge that at the time of this writing the public protests in Hong Kong have escalated beyond what had been largely peaceful demonstrations. Hong Kong as an economic entity is not significant to our long-term

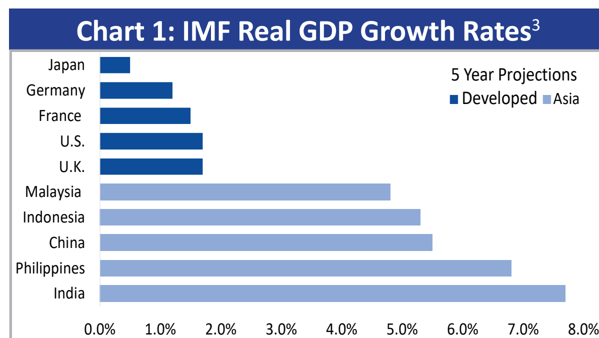
[1] Source: Bloomberg. 1.5% growth assumes third quarter consensus earnings are achieved. [2] Source: Bloomberg.

thesis on Asia generally, and China specifically, as the real wealth creation happens on the mainland. However, many public companies are listed in Hong Kong and the current turmoil is disruptive. It is likely that the strife in Hong Kong could end without having had a significant economic or political impact on China, and a permanent U.S.-China trade war seems counterproductive to both sides, but unless these two factors create a significant valuation re-rating in Chinese stocks, it seems prudent to postpone additional equity investments in China for the time being.

Longer-term, applying a similar lens of growth, valuation, and policy to the deployment of capital, we continue to view Asia as an attractive source for capital with several geographies that merit rigorous analysis.

- **Growth:** Chart 1 shows IMF projected economic growth over the next five years. Growth projections for some select Asian countries versus developed market peers reveals a wide gap favoring Asia's structural advantages.

Chart 1: IMF Real GDP Growth Rates[3]



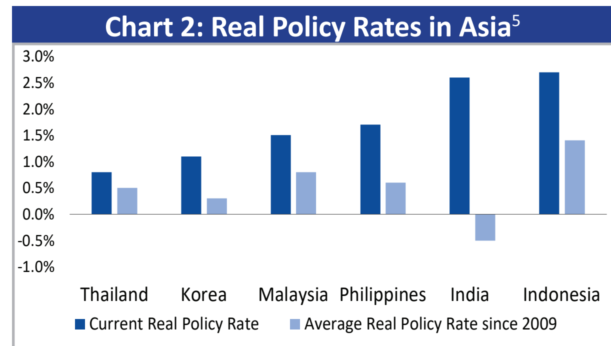
- **Valuation:** Asia, as a region, remains substantially cheaper than the U.S. on a variety of metrics including price/earnings, price/book, price/sales and dividend yield (Table 2).

Table 2: Valuations[4]

	U.S.	Asia ex-Japan
P/E	18.0x	13.9x
P/B	3.4x	1.4x
P/S	2.2x	1.2x
Div. Yield	1.9%	2.7%

- **Policy:** Monetary policy in many Asian economies has room for interest rates to be reduced when needed. Chart 2 illustrates that current real policy rates are higher than historical rates since the financial crisis, an indication that a monetary policy lever is still available if, or when, needed.

Chart 2: Real Policy Rates in Asia[5]



The immediate narrative is that China is the most impacted country in the current trade war. To some degree Asia has been simplistically painted with this same negative broad brush without taking into consideration basic counter effects. For example, the movement of U.S. supply chains from China will create opportunities for other Asian economies to step into the void due to geographic proximity and low labor costs. This shift had already started with certain types of manufacturing that require low(er) wages. Now it is being expanded, but it remains modest relative to the scale of China's very large economy while being incrementally positive for economies in SE Asia which are notably smaller.

In addition to monetary policy, there are a myriad of other fiscal levers that can be pulled in Asia. India, as an example, surprised observers by passing a meaningful corporate tax cut in September. Positive impacts will include higher corporate profit margins and earnings. A more globally competitive tax regime will attract foreign direct investment where previously the tax signal had been ambiguous. India has also implemented new bankruptcy laws and bank reforms, an additional effort to clean up credit channels and catalyze investment in an economy that has one of the most attractive demographic profiles we have seen.

Asian equity indices have shown modest appreciation in the last decade versus the U.S., but we think the underlying improvement in growth, valuation, and policy should start to accrue to investors and active investment managers that are best positioned to navigate a dynamic opportunity set.

[3] Source: IMF. [4] Source: Bloomberg. [5] Source: GaveKal.